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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1518

WILLIAM H. GORDON and FERN GORDON, his wife,
Petitioners,

vs.

du PONT GLORE, FORGAN, INC.,
Respondent

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

April 8, 1974

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vs.

du PONT GLORE, FORGAN, INC.,
Respondent

PETITION FOR CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

APRIL ____, 1974

The Petitioners, WILLIAM H. GORDON and FERN GORDON, his wife, respectfully pray that a Writ of Certiorari issue to review the judgment and opinion herein of the United States Court of Appeals for the Fifth Circuit entered in the above entitled case on December 10, 1973, Petition for Re-hearing denied on January 10, 1974.

OPINIONS BELOW

The Judgment of the United States District Court for the Southern District of Florida, was not reported, but is printed in the Appendix. The opinion of the United States Court of Appeals for the Fifth Circuit was reported at 487 F.2d 1260, (1973) and also appears in the Appendix.

JURISDICTION

The opinion of the United States Circuit Court of Appeals for the Fifth Circuit was entered on December 10, 1973, and a timely Petition for Re-hearing was filed and subsequently denied on January 10, 1974. This Petition for Certiorari was filed within ninety (90) days of the date of the Appellate Court's denial of the Appellee/ Cross Appellants' Petition for Re-Hearing.

This Court's jurisdiction is invoked under Title 28, Section 1254 (1) of the United States Code.

QUESTIONS PRESENTED

1. WHETHER A STOCK BROKER, WHO IS A MEMBER OF THE NEW YORK STOCK EXCHANGE AND WHO VIOLATES RULES 431 AND 432, OF THE NEW YORK STOCK EXCHANGE, WHICH VIOLATIONS CAUSE DAMAGE TO A CUSTOMER, CREATES A PRIVATE CIVIL CAUSE OF ACTION UNDER THE 1934 SECURITIES EXCHANGE ACT.

2. WHETHER THE DEFENSE OF "IN PARI DELICTO" IS AVAILABLE TO A STOCK BROKER WHO VIOLATES FEDERAL MARGIN REQUIREMENTS, WHICH VIOLATION CAUSES DAMAGE TO ITS CUSTOMER.

3. WHETHER THE DEFENSE OF "IN PARI DELICTO" IS AVAILABLE TO A STOCK BROKER WHO VIOLATES MARGIN MAINTENANCE REQUIREMENTS, WHICH VIOLATION CAUSES DAMAGE TO ITS CUSTOMER.

4. WHETHER THE DEFENSE OF RATIFICATION OR ESTOPPEL BY CONDUCT IS AVAILABLE TO A STOCK BROKER WHO VIOLATES MARGIN MAINTENANCE REQUIREMENTS, WHICH VIOLATION CAUSES DAMAGE TO ITS CUSTOMER.

STATUTE AND REGULATIONS INVOLVED

The Statute involved is the Securities Exchange Act of 1934, 15 U.S.C. Sections 78a et. seq. The relevant provisions are 15 U.S.C. 78f; 78g(a); 78g(c) (1) and (2); 78g(d); 78s. Because these provisions are lengthy, their pertinent text is set forth in the Appendix. The regulations involved are, Federal Reserve Board Regulation T, 12 C.F.R. Section 220; New York Stock Exchange Rules 431(b)(1) and (6), and New York Stock Exchange Rule 432(a). Because these regulations and rules are lengthy their pertinent text is also set forth in the Appendix.

STATEMENT OF THE CASE

This Petition concerns an action by the Petitioners, WILLIAM H. GORDON and FERN GORDON, his wife (hereinafter "The Gordons"), against the Respondent, du PONT GLORE, FORGAN INCORPORATED (hereinafter "duPont"), for losses sustained as a result of depreciation on the value of stock held in their margin account with duPont. Count I of the Complaint alleged that the losses would not have occurred but for duPont's alleged failure to comply with certain rules of the New York Stock Exchange and of the National Association of Securities Dealers, which failure the Gordons contend was actionable under the Securities Exchange Act of 1934. Count II of the Complaint alleged that duPont in accepting the Gordons' accounts failed to tell them that duPont would not notify them of the financial condition of their accounts before it was too late to prevent the loss they sustained, which failure, the Gordons contended constitutes a violation of Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5, 17 C.F.R. 240, 10b-5, pro-

mulgated thereunder. Count III was a common law count based on an alleged fiduciary relationship between the Gordons and duPont, the breach of which, the Gordons contended caused their loss.

In addition to denying liability under the several counts, duPont counterclaimed for the deficiency in the Gordons' account that remained when the stocks therein were liquidated by duPont when it deemed such action necessary for its protection.

The Gordons maintained cash and margin stock brokerage accounts with duPont for the purchase and sale of securities. DuPont's agent, Morton Frank, arranged the accounts so that each guaranteed the other, so that all of the Gordons' accounts would be treated as one for the purpose of margin requirements. In addition, duPont's agent arranged to lower the minimum margin maintenance requirement from the firm imposed limit of 30% of market price to the New York Stock Exchange limit prescribed by Rule 431(b)(1) of 25% of market price so as to enable the Gordons to engage in additional transactions with the same amount of capital.

At the time, duPont's agent made the margin arrangements, he orally notified the Gordons that the onus was on them to compute their own margin balance, for the purposes of minimum maintenance requirements.

The Trial Court found, from the testimony presented, that during the time prior to July 14, 1973, that said accounts were on the 25% maintenance requirement and that duPont had issued margin calls on numerous occasions. The Trial Court further found that these margin

calls were of the standard type, originating from the New York office, and were properly met by the Gordons.

On July 14, 1971, the Gordons account dropped below the 25% minimum maintenance required by Rule 431 of the New York Stock Exchange. At that time, the account contained an equity balance of approximately $20,000 which had been stipulated to by duPont's counsel. DuPont did not notify the Gordons as to the condition of their account until November 22, 1971, at which time, there was a debit balance of $9,500.

After the Gordons' refusal to deposit $9,500 to bring the accounts up to a zero balance, duPont liquidated the account, which resulted in a $1,500.30 deficit.

At Trial, counsel for duPont stipulated that the Gordon's accounts dropped below the 25% minimum margin maintenance required by Rule 431(b)(1) of the New York Stock Exchange on July 14, 1971. Counsel for duPont further stipulated that if duPont was ruled to be liable for their failure to notify the Gordons promptly, then their damages would be $20,000.

Plaintiff's counsel stipulated that the Gordons became aware that the account was under-margined within a reasonable period of time after July 14, 1971.

At the conclusion of a non-jury trial, the lower court entered an Order dismissing Counts I and II for failure to present a federal question. The trial court, then entered Final Judgment for $20,000 against duPont on the grounds that duPont breached its fiduciary duty to notify the Gordons as to the condition of their accounts, pursuant to Count III of the Gordons' Complaint.

DuPont appealed the judgment of the trial court to the United States Court of Appeals for the Fifth Circuit, and the Gordons took a cross-appeal upon the trial court's dismissal of Count I of their Complaint, claiming that duPont's violation of the New York Stock Exchange Rules does give rise to a private right of action under the Securities Exchange Act of 1934.

Upon appeal, the Fifth Circuit, reversed the Judgment of the lower court, on the basis that the Gordons had tacitly ratified duPont's breach of fiduciary duty and were estopped by their conduct to recover damages. The Fifth Circuit, while stating that there were no cases directly on Point, relied upon the case of *Hayden, Stone Inc., v. Brown*, 218 So.2d 230 (2nd D.C.A., Fla. 1969), cert. denied, 225 So.2d 539, which case adopted the view of *Carr v. Warner*, 137 F.Supp. 611 (D.Mass 1955).

As to the Gordons' cross-appeal, the Fifth Circuit stated that the Gordons had filed the appeal anticipating a reversal on duPont's direct appeal. The Appellate Court held, that they were in disagreement with *Pearlstein v. Scudder & German*, 429 F.2d 1136 (2d Cir. 1970), cert. denied, 401 U.S. 1013, wherein the United States Court of Appeals for the Second Circuit held that a customer could recover from his broker, even though he knew the broker had failed to comply with the Federal Reserve Board's Regulation T, 12 C.F.R. 220, for initial-purchase margin requirements.

The Fifth Circuit further held, that it would not always be improper to impose civil liability under Rules 431 and 432 of the New York Stock Exchange, but that there is no right of action that will allow recovery to a customer who knows his account is under-margined.

REASONS FOR GRANTING THE WRIT

The case at Bar presents conflicting principals of law between the Fifth Circuit, and the Second and Seventh Circuits.

The Federal Courts have recognized private causes of action by investors against brokers to recover losses resulting from margin violations. In addition, the Courts have permitted the investor to raise said violation as an affirmative defense to lender claims. Public policy was one of the reasons the Courts have consistently recognized private causes of action as a supplement to official enforcement of margin regulations.

In the landmark case of *Pearlstein v. Scudder & German* 295 F.Supp. 1197 (S.D.N.Y. 1968), 429 F.2d 1136 (2d Cir. 1970) (Rev'd. on other grounds), cert. denied, 401 U.S. 1013, the Second Circuit held that even if the Plaintiff was an experienced investor and was presumed to have knowledge of Regulation T, he should not be denied recovery where the broker has violated same. Reversing the case on other grounds, the Appellate Court upheld the lower Court's ruling on the implied right of civil action, and its reasoning therein.

The first case to deal specifically with the issue of whether a brokerage firm could be held liable in a private cause of action for a violation of New York Stock Exchange or National Association of Securities Dealers rule, was *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966), cert. denied, 385 U.S. 817 (1966). Although, the Second Circuit affirmed the ruling of the Trial Court, that no Federal claim, pursuant to New York

Stock Exchange Rules, existed on the Plaintiff's allegations, it did so only after carefully analyzing the specific rule and the legislative intent.

Judge Friendly held that in determining whether a violation of an Exchange rule will give rise to a private cause of action, one must determine: 1) Whether there is an explicit statutory condemnation of certain conduct and a general grant of jurisdiction to enforce the liabilities created by the Statute; and 2) whether the legislature intended such protection and the administrative and judicial remedies are ineffectual to achieve that end at present. Id. at 181.

The Court went on to hold that a private right of action would be most acceptable, if the rule was specific, rather than a vague general admonition.

One of the most important cases on this subject following *Colonial* supra, was *Buttery v. Merrill, Lynch, Pierce, Fenner & Smith*, 410 F.2d 135 (7th Cir. 1969), cert. denied, 396 U.S. 838 (1969), wherein a Trustee in bankruptcy established a cause of action against a member of the New York Stock Exchange based upon the member's violation of Rule 405, known as the "Know Your Customer Rule." Without explicitly rejecting the *Colonial Realty* opinion, the *Buttery* Court ignored such factors as whether the self-regulatory rule imposed a duty unknown at common law or could be viewed as a substitute S.E.C. Regulation.

In a case subsequent to *Buttery*, supra, the Seventh Circuit spoke again, this time on the question of whether there was a cause of action pursuant to §2 of Article III

of the National Association of Securities Dealers Rules of Fair Practice, better known as the "Suitability Rule". The Court, in *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969), cert. denied, 385 U.S. 817 (1969), held that the lower court's dismissal of Plaintiff's cause of action based upon the Suitability Rule was improper, but not prejudicial in that the same theory was incorporated in another claim.

In yet another Seventh Circuit case, *Securities Exchange Commission v. First Securities Co.*, 463 F.2d 981 (7th Cir. 1972), cert. denied, 93 S.Ct. 85 (1972), the Court held a brokerage firm liable for damages, pursuant to Section 27 of the National Association of Securities Dealers Rules of Fair Practice, as a result of its failure to inspect and review business correspondence of an employee

As previously stated, the United States Court of Appeals for the Fifth Circuit held in the case at Bar, that pursuant to Rules 431 and 432 of the New York Stock Exchange, there is no right of action that will allow recovery to an investor who knows his account is undermargined on the grounds to do so would be inequitable. In so holding, the Appellate Court specifically, as well as impliedly, disagreed with the Second Circuit's decision in *Pearlstein*, supra, with regard to an investors prior knowledge of a federal margin requirement violation.

Violation of margin requirements often involves culpability on the part of both the broker and investor. The defense of "pari delicto", the equitable doctrine which denies relief to a Plaintiff at equal fault with the Defendant, has been soundly rejected.

In *Pearlstein*, supra, the Second Circuit allowed recovery to an investor who was aware that the transaction violated margin requirements.

The Court in *Pearlstein*, supra, indicated that a person who has knowledge of a margin violation, as duPont alleges in the case at Bar, is not subject to the defense of "pari delicto" since, "Congress has placed the responsibility for observing margins on the broker". *Pearlstein*, supra, at 1141. It is implied, as a matter of law, that the onus is on the broker to enforce compliance with the minimum margin maintenance requirements and that the broker's failure to do so will result in liability.

The foregoing cases, although not directly on point with the case at Bar are, as previously stated, similar and analogous to the factual situation presented herein. The common thread that runs through the cases and the case at Bar, is that, regardless of Plaintiff's complicity or knowledge, the broker is liable, if it does not properly liquidate the Plaintiff's account when required by statute, rule, regulation or, when reasonably necessary, so as to protect the investor and the investing public. See also: *Spoon v. Walston & Company*, 345 F.Supp. 518 (E.D. Mich. S.D. 1972).

It is of paramount importance that this Court resolve the clear conflict of legal principles created by the Fifth Circuit's opinion below. It is in the public interest that there be uniformity of decisions throughout the circuits, with regard to the interpretation of the securities laws enacted by Congress and the rules and regulations promulgated thereunder, which laws, rules and regulations were specifically enacted to protect the investor (i.e., the public).

To have a number of conflicting decisions interpreting the same section of the Securities Exchange Act of 1934 and the rules and regulations which were promulgated thereunder, would not only be unduly burdensome to the investor and the stock brokerage firms as well, but it would most certainly disrupt the orderly flow of interstate commerce; for a stock broker could be held liable as a matter of law for violation of margin requirements in one section of the country, and in another section, the broker's liability would depend on a factual issue of the customer's foreknowledge of said margin violation. (See p. 27 of the Appendix herein).

The economy of this country rests, in part, upon the orderly function of the securities markets. This orderly function could be severely disrupted, if the conflicts created by the lower Court's decision herein, are not resolved, in that, in the future, the forum where the securities transaction takes place will govern the right of the investor's recovery for a stock broker's violation of Federal Securities Law, or rules and regulations promulgated thereunder. This would result in a drastic shift of securities transactions to those forums which extend to the investor, the full protection of the securities laws, rules and regulations, which protection is not subject to interpretation of paper issues or conflicting testimony as to facts that do not relate directly upon whether or not a violation of a Securities law, rule or regulation, has taken place.

CONCLUSION

It is respectfully requested that a Writ of Certiorari, be granted to review the opinion of the United States Court of Appeals for the Fifth Circuit, and resolve the conflicting principles of law created therein, thereby creating uniformity between the circuits with regard to liability of a stock broker for violation of margin requirements pursuant to Federal Securities laws, rules or regulations promulgated thereunder.

Respectfully submitted,

BY:_____

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IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

NO. 72-364-Civ. NCR (Judge Roettger)

WILLIAM H. GORDON and
FERN GORDON, his wife,

Plaintiffs,

vs.

duPONT GLORE FORGAN INCORPORATED,
a Delaware Corporation,

Defendant.

FINAL JUDGMENT FOR PLAINTIFFS

[Filed November 30, 1972]

THIS CAUSE, having come on before me for Non-Jury Trial pursuant to notice to the parties, and the Court having heard and considered the testimony of the respective parties hereto and having examined and considered the oral and documentary evidence submitted and, at the conclusion of the trial, having entered an Order dismissing Counts 1. and 2. of the Plaintiffs' Complaint, and being further duly advised in the premises, the Court makes the following findings of fact:

1. That the parties stipulated, at the commencement of the trial, that the Plaintiffs' damages would be set at Twenty Thousand Dollars ($20,000.00) in the event they were successful in this action.

2. That MORTON FRANK was the authorized employee of the Defendant corporation who personally supervised the Plaintiffs' brokerage account.

3. That MORTON FRANK had previously been a practicing attorney in Miami Beach, Florida and a member in good standing of the Florida Bar for a period of approximately ten years.

4. That MORTON FRANK had been a social friend of the Plaintiffs for a period of several years and a person in whom they reposed trust and confidence.

5. That a fiduciary relationship existed between the Plaintiffs and the Defendant in this action.

6. That as a direct result of the Defendant's failure to notify the Plaintiffs as to the financial condition of their account, after having previously done so on numerous occasions, that such failure, which resulted in the Plaintiffs losing all of their equity in their stock brokerage account, was a breach of the fiduciary relationship existing between the parties.

It is, accordingly,

ORDERED and ADJUDGED:

That the Plaintiffs are hereby awarded Judgment against the Defendant in the sum of Twenty Thousand Dollars —($20,000.00) plus interest from March 8, 1972 to November 24, 1972 in the amount of Eight Hundred Sixty Dollars ($860.00).

That the Plaintiffs shall recover Court costs to be taxed hereafter, for which sums let execution issue.

As to the Counterclaim filed in this action, the Counterplaintiff shall take nothing by its suit and the Counterdefendants shall go hence without day.

DONE and ORDERED this 30 day of November, 1972 at Miami, Dade County, Florida.

NORMAN C. ROETTGER, JR.

UNITED STATES
DISTRICT JUDGE

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 73-1382

WILLIAM H. GORDON and
FERN GORDON, his wife,
Plaintiffs-Appellees-Cross Appellants,

versus

duPONT GLORE FORGAN INCORPORATED,
Defendant-Appellant-Cross Appellee.

Appeals from the United States District Court
for the Southern District of Florida

(December 10, 1973)

Before THORNBERRY, SIMPSON and CLARK,
Circuit Judges.

THORNBERRY, Circuit Judge: The court below awarded the Gordons $20,000 for damages resulting from defendant brokerage firm's failure to notify them that their account was undermargined, a breach of its fiduciary duty. On appeal duPont contends that the Gordons' knowledge of their account's undermargined condition operates as ratification and a bar to this suit, and duPont is entitled to recover the deficiency remaining after it closed the Gordons' account. On cross appeal the Gordons find error in the trial court's dismising their claim alleging a cause of action under the rules of the New York

Stock Exchange. We reverse the judgment against duPont and deny its counterclaim and appellees' cross appeal.

New York Stock Exchange Rule 431[1] sets the minimum permissible margin maintenance level at twenty-five percent. That is, if one chooses to trade on margin, he must always have equity in his margin account equal to at least twenty-five percent of his stock's market value. Appellant set its own margin maintenance requirement at thirty percent, and its computer is programmed to give a warning when margin accounts fall below that level.

In this case, however, duPont did not utilize the computer because it had granted the Gordons a special dispensation by lowering their margin requirement to twenty-five percent. The task of overseeing the Gordons' margin status fell to Morton Frank, their broker. He inadvertently allowed their account to become undermargined on July 14, 1971, and they became aware of the undermargining a "reasonable period of time" afterwards.[2] Frank finally discovered his error on November 22, 1971, and immediately asked Mr. Gordon for more margin. Gordon

[1]The rule provides, in pertinent part:

(b) The margin which must be maintained in margin accounts of customers, whether members, allied members, member organizations or nonmembers, shall be as follows:

(1) 25% of the market value of all securities "long" in the account; . . .

[2]The Gordons' attorney stipulated before trial that Mr. Gordon became aware that his account was undermargined at "a reasonable period of time after July 14th" and before November. Mr. Gordon received monthly account statements and examined them with care. Therefore we interpret this unusual, enigmatic stipulation to mean that he learned of the undermargining no later than the receipt of his first monthly statement following July 14, and we assume he was informed by mid-August.

declined to meet this margin call, and negotiations ensued. When Frank made one last margin call on November 29, Gordon demurred, saying he would like to wait until 3:30 p.m. that day before making a decision. Unable to wait any longer, Frank liquidated the Gordons' account. The sale fell $1550 short of satisfying the Gordons' debt to duPont, and duPont's counterclaim seeks to recover this deficit.

The trial court found that duPont breached its common law fiduciary duty to the Gordons when it failed to notify them promptly after their account became undermargined. The court awarded damages of $20,000, the account's equity value when it first became undermargined on July 14, 1971. In other words, if duPont had liquidated the Gordons' account on the day it first became undermargined, their debt to duPont would have been satisfied with $20,000 to spare.

In determining whether the Gordons are entitled to recover damages for duPont's breach of its fiduciary duty we must remember that they knew their account's true condition for several months while they waited silently for Frank to discover his mistake. The effect of such behavior on their right to recover is a state law question.

While no Florida case is directly in point, a Florida appellate court dealt with an analagous situation in Hayden, Stone, Inc. v. Brown, Fla. Ct. App. 1969, 218 So.2d 230, cert. denied, 225 So.2d 539 (Sup. Ct. Fla.) In that case plaintiff charged that his stockbroker negligently recommended speculative, volatile stocks and failed to supervise his account properly. However, the evidence showed that plaintiff was aware of the nature of the stocks bought for

him, and he approved each purchase. He received monthly statements showing the status of his account, and he never objected to the way his account was being handled. In light of that evidence the court adopted the view of the court in Carr v. Warner, D. Mass. 1955, 137 F.Supp. 611.

> Even if there had been a breach of duty . . . plaintiff by repeatedly accepting confirmations and accounts, which fully disclosed all aspects of the transactions, elected not to rely upon that breach. Moreover, by failing seasonably to make complaints of facts of which she was informed, she would in any event be barred from her later assertion of wrong done unto her by the partnership or corporation.

137 F.Supp. at 615.

As we read Hayden, Stone, under Florida law a customer who knows of his broker's breach of duty and takes no action will be barred from bringing suit. In the instant case Mr. Gordon knew "a reasonable period of time after July 14" that his account was undermargined and merely waited for his broker to discover the mistake. He did not rely upon the breach, and he did not seasonably complain. He knew of the breach of duty and he acquiesced. Such behavior must bar his recovery here.

In its counterclaim duPont seeks to recover the $1550 deficiency that remained after the Gordons' account was closed. When the Gordons opened their account, they authorized duPont to sell all their securities if they failed to meet a margin call, and they agreed to be liable for any deficiency that remained after the sale.

While it is true that the Gordons had a contractual obligation to make up the $1550 deficit, it is also true that the deficit was at least partially the result of duPont's failure to compute the margin status correctly and give prompt notice of the undermargining. We cannot allow duPont to recover indebtedness that resulted from its own breach of duty, and therefore we must reject its counterclaim. See Goldenberg v. Bache and Co., 5th Cir. 1959, 270 F.2d 675, 681.

Perhaps anticipating our negative ruling on their common law claim, the Gordons urge that we find an implied private right of action under N.Y.S.E. rules 431 and 432[3] governing margin maintenance and brokers' record keeping. They acknowledge that no circuit court has found such a right of action under these particular rules, but they fashion a precedent for us by reading two circuit cases together.

The Seventh Circuit has said that other stock exchange rules will support a private right of action. Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, 7th Cir. 1969, 410 F.2d 135, cert. denied, 396 U.S. 838 (Rule 405, the know-your-customer rule). And the Second Circuit has held that a private cause of action exists under the initial-

[3]Rule 432 provides, in pertinent part:

(a) Each member organization carrying securities margin accounts for customers shall make each day a record of every case in which, pursuant to the rules of the Exchange or regulations of the Board of Governors of the Federal Reserve System, initial or additional margin must be obtained in a customer's account because of the transactions effected in the account on that day. The record shall be preserved for at least twelve months, and shall show, for each account, the amount of margin so required and the time when and manner in which the margin is furnished or obtained. The record shall be maintained in a manner satisfactory to the Exchange.

purchase margin requirements set out in Regulation T,[4] which implements section 7 of the Securities Exchange Act of 1934.[5] Pearlstein v. Scudder & German, 2d Cir. 1970, 429 F.2d 1136, cert. denied, 401 U.S. 1013. Thus the way is clear, we are told, to synthesize these two holdings and imply a right of action under the stock exchange rules setting margin maintenance standards.

Even if we created a right of action under stock exchange rules, the problem of the Gordons' prior knowledge remains. It is their apparent hope that such a new cause of action will treat them less harshly than did the common law. That theory is buttressed by Pearlstein, supra, in which the court said a stockholder could recover from his broker even though he knew the broker had failed to comply with Regulation T's initial-purchase margin requirements.

With all due deference to the Second Circuit, we must disagree with an approach that so unilaterally favors the stock purchaser at the expense of his broker. The case before us illustrates the inequitable results that can flow from such an approach. The broker inadvertently miscalculated the Gordons' margin. The error did not cloak them in ignorance, however, because Gordon received periodic account statements from duPont and discovered the undermargining "a reasonable period of time" after it occurred. The broker's error instead allowed Gordon to avoid bothersome margin calls while his equity dwindled. He could gamble that his stock would appreciate in value without having to bolster his margin account with resources he could employ elsewhere. And when his stock fell so low that his margin account had a deficit instead

[4] 12 C.F.R. § 220.

[5] 15 U.S.C.A. § 78g.

of equity he had no incentive at all to put up more margin, for he could simply let the broker sell him out and let duPont take part of the loss. In fact that is what he did.

But, it can be argued, if we give stock purchasers a broad right of action unencumbered by an in pari delicto defense, we will help enforce the stock exchange rules by deterring the brokers who might desire to violate them. This brings to mind the words of Judge Friendly:

> Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who . . . is placed in the enviable position of "heads-I-win tails-you-lose."

Pearlstein v. Scudder & German, 2d Cir. 1970, 429 F.2d 1136, 1148 (Friendly, J., dissenting).

Thus we hold that under Rules 431 and 432 there is no right of action that will allow a recovery to investors who know their accounts are inadvertently undermargined, maintain their silence for a substantial period of time, and take no corrective action. We do not hold that it would always be improper to impose civil liability under these two rules, nor do we say a right of action can never be implied under stock exchange rules generally. We simply express no opinion beyond the narrow holding of this case.

The judgment of the district court is REVERSED in part and AFFIRMED in part. Each party will pay his own costs.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 73-1382

WILLIAM H. GORDON and
FERN GORDON, his wife,
Plaintiffs-Appellees-Cross Appellants,

versus

duPONT GLORE FORGAN INCORPORATED,
Defendant-Appellant-Cross Appellee.

Appeals from the United States District Court
for the Southern District of Florida

ON PETITION FOR REHEARING
[Filed January 10, 1974]

Before THORNBERRY, SIMPSON and CLARK,
Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby Denied.

15 U.S.C. 78f
(Securities Exchange Act 1934, Section 6)

78f. Registration of national securities exchanges.—(a) Any exchange may be registered with the Commission as a national securities exchange under the terms and conditions hereinafter provided in this section, by filing a registration statement in such form as the Commission may prescribed, containing the agreements, setting forth the information, and accompanied by the documents, below specified:

(1) An agreement (which shall not be construed as a waiver of any constitutional right or any right to contest the validity of any rule or regulation) to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of this title [§§ 78a-78d, 78e-78l, 78m-78o, 78o-3—78hh of this title], and any amendment thereto and any rule or regulation made or to be made thereunder;

(2) Such data as to its organization, rules of procedure, and membership, and such other information as the Commission may by rules and regulations require as being necessary or appropriate in the public interest or for the protection of investors;

(3) Copies of its constitution, articles of incorporation with all amendments thereto, and of its existing bylaws or rules or instruments corresponding thereto, whatever the name, which are hereinafter collectively referred to as the "rules of the exchange"; and

(4) An agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption.

(b) No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade and declare that the willful violation of any provisions of this title [§§ 78a-78d, 78e-78l, 78m-78o, 78o-3— 78hh of this title] or any rule or regulation thereunder shall be considered conduct or proceeding with just and equitable principles of trade.

(c) Nothin in this title l§§ 78a-78d, 78e-78l, 78m-78o, 78o-3—78hh of this title] shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title [§§ 78a-78d 78e-78l, 78m-78o, 78o-3—78hh of this title] and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(d) If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title [§§ 78a-78d, 78e-78l, 78m-78o, 78o-3— 78hh of this title] and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

(e) Within thirty days after the filing of the application, the Commission shall enter an order either granting or, after appropriate notice and opportunity for

hearing, denying registration as a national securities exchange, unless the exchange applying for registration shall withdraw its application or consent to the Commission's deferring action on its application for a stated longer period after the date of filing. The filing with the Commission of an application for registration by an exchange shall be deemed to have taken place upon the receipt thereof. Amendments to an application may be made upon such terms as the Commission may prescribe.

(f) Any exchange may, upon appropriate application in accordance with the rules and regulations of the Commission, and upon such terms as the Commission may deem necessary for the protection of investors, withdraw its registration.

15 U.S.C. 78g(a); (c)(1) & (2);(d)
(Securities Exchange Act 1934, Section 7)

78g. Margin requirements.— (a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Federal Reserve Board [Board of Governors of the Federal Reserve System] shall, prior to the effective date of this section [Oct. 1, 1934] and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of—

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

* * * *

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

(d) It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Federal Reserve Board [Board of Governors of the Federal Reserve System] shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to a

loan by a bank on a security other than an equity security, or (E) to such other loans as the Federal Reserve Board [Board of Governors of the Federal Reserve System] shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

15 U.S.C. 78(a)(1) & (3); (b)
(Securities Exchange Act 1934, Section 19)

78s. Powers with respect to exchanges and securities.—(a) The Commission is authorized, if in its opinion such action is necessary or appropriate for the protection of investors—

(1) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to withdraw the registration of a national securities exchange if the Commission finds that such exchange has violated any provision of this title [§§78a-78d, 78e-78l, 78m-78o, 78o-3—78hh of this title] or of the rules and regulations thereunder or has failed to enforce, so far as is within its power, compliance therewith by a member or by an issuer of a security registered thereon.

* * *

(3) After appropriate notice and opportunity for hearing, by order to suspend for a period not exceeding twelve months or to expel from a national securities exchange any member or officer thereof whom the Commission finds has violated any provision of this title

[§§78a-78d, 78e-78l, 78m-78o, 78o-3—78hh of this title] or the rules and regulations thereunder, or has effected any transaction for any other person who, he has reason to believe, is violating in respect of such transaction any provision of this title [§§78a-78d, 78e-78l, 78m-78o, 78o-3—78hh of this title] or the rules and regulations thereunder.

* * * *

(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries, and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained

by or with the consent or the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sale; (12) minimum deposits on margin accounts; and (13) similar matters.

* * * *

Pertinent Portions of: 12 C.F.R. 220
(Federal Reserve Board Regulation T)

§220.1 Scope of part.

This part is issued by the Board of Governors of the Federal Reserve System (hereinafter called the "Board") pursuant to the Securities Exchange Act of 1934 (called the "Act" in this part), particularly sections 7 and 8(a) thereof (15 U.S.C. 78g, 78h(a), as amended), and applies to every broker or dealer, including every member of a national securities exchange.

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§220.3 General account.

* * *

(b) General rule. (1)(i) A creditor shall not effect for or with any customer in a general account, special bond account subject to §220.4(i), or special convertible debt security account any transaction which, in combination with the other transactions effected in such account on the same day, creates an excess of the adjusted debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess, unless in connection therewith the creditor obtains,

as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created or the increase so caused.

(ii) If the adjusted debit balance in a general account or special convertible debt security account, computed using the margin requirement for short sales specified in §220.8(g)(2) of the Supplement to Regulation T, exceeds the maximum loan value of the securities in such account specified in §220.8(g)(1), the account is subject to §220.8(g) (sometimes referred to herein as "account subject to section 8(g)"). If an account is subject to §220.8(g) as of the close of business on the preceding business day, it shall be subject in addition to all other requirements applying to the account, to the requirement that the creditor shall not effect any transaction in the account which creates an excess of the adjusted debit balance of such account, computed using the margin requirements for short sales specified in §220.8(d), over the maximum loan value of the securities in such account specified in §220.8(a) and (c), or increases any such excess, unless in connection therewith the creditor obtains, as promptly as possible and in any event before the expiration of 5 full business days following the date of such transaction, the deposit into such account of cash or securities in such amount that the cash deposited plus the loan value of the securities deposited equals or exceeds the excess so created or the increase so caused. The required deposit may be reduced by the amount of cash or securities which otherwise could be withdrawn pursuant to the

provisions of subparagraph (2) of this paragraph in connection with any other transactions in the account on the same day.

(2) Except as permitted in this subparagraph, no withdrawal of cash or exempted or margin securities shall be permissible if the adjusted debit balance of the account (whether the general account, the special bond account, or the special convertible security account) would exceed the maximum loan value of the securities in such account after such withdrawal. The exceptions are available only in the event no cash or securities need to be deposited in such account in connection with a transaction on a previous day and none would need to be deposited thereafter in connection with any withdrawal of cash or securities on the current day. The permissible exceptions are (i) registered nonequity securities or exempted securities held in the general account on March 11, 1968, and continuously thereafter may be withdrawn upon the deposit in the account of cash (or margin equity securities counted at their maximum loan value) at least equal to the "retention requirement" of such withdrawn securities, or (ii) except as provided in subdivision (i) of this subparagraph, securities having loan value in the general account, the special bond account, or the special convertible security account may be withdrawn upon the deposit in such account of cash or securities having loan value in such account counted at the maximum loan value at least equal to the "retention requirement" of those securities, or (iii) cash may be withdrawn upon the deposit in the general account, the special bond account, or the special convertible bond account of securities having a maximum loan value in such account at least equal to the amount of cash withdrawn, or (iv) upon the sale (other than the short sale) of securities

having loan value in the general account, special bond account, or special convertible security account there may be withdrawn in cash an amount equal to the difference between the current market value of the securities sold and the "retention requirement" of such securities, or (v) upon the sale (other than the short sale) of a registered nonequity security or an exempted security that was held in the general account on March 11, 1968, and continuously thereafter there may be withdrawn in cash an amount equal to the difference between the current market value of the securities sold and the "retention requirement" of those securities as prescribed in §220.8 (the supplement to Regulation T).

(3) Rules for computing the maximum loan value of the securities in a general account, special bond account, or special convertible security account and the adjusted debit balance of such account are provided in paragraphs (c) and (d) of this section, and certain modifications of and exceptions to the general rule stated in this paragraph are provided in the subsequent paragraphs of this section and in §220.6.

* * * *

(e) Liquidation in lieu of deposit. In any case in which the deposit required by paragraph (b) of this section, or any portion thereof, is not obtained by the creditor within the 5-day period specified therein, margin nonexempted securities shall be sold (or, to the extent that there are insufficient margin nonexempted securities in the general account, special bond account, or special convertible security account other liquidating transactions shall be effected in such account), prior to the expiration of such 5-day period, in such amount that the resulting decrease in the adjusted debit balance of such account exceeds, by

an amount at least as great as such required deposit or the undeposited portion thereof, the "retention requirement" of any margin or exempted securities sold: Provided, That a creditor is not required to sell securities or to effect other liquidating transactions specified by this paragraph in an amount greater than necessary to eliminate the excess of the adjusted debit balance of such account over the maximum loan value of the securities remaining in such account after such liquidation.

(f) Extensions of time. In exceptional cases, the 5-day period specified in paragraph (b) of this section may, on application of the creditor, be extended for one or more limited periods commensurate with the circumstances (1) by any regularly constituted committee of a national securities exchange having jurisdiction over the business conduct of its members, of which exchange the creditor is a member or through which his transactions are effected, or (2) in instances where the procedure described above is not readily available or appropriate, by a committee of a national securities assocation: Provided, That such committee is satisfied that the creditor is acting in good faith in making the application and that the circumstances are in fact exceptional and warrant such action.

New York Stock Exchange Rule 431(b)(1) & (6)

"Maintenance margin rule

* * * *

(b) The margin which must be maintained in margin accounts of customers, whether members, allied members, member organizations or non-members, shall be as follows:

(1) 25% of the maket value of all securities "long" in the account; plus

* * *

(6) Time Within Which Margin, Deposit or "Mark to Market" Must Be Obtained — The amount of margin, deposit or "mark to market" required by any provision of this Rule shall be obtained as promptly as possible and in any event within a reasonable time."

New York Stock Exchange Rule 432(a)

"Daily Record of Required Margin

(a) Each member organization carrying securities margin accounts for customers shall make each day a record of every case in which, pursuant to the rules of the Exchange or regulations of the Board of Governors of the Federal Reserve System, initial or additional margin must be obtained in a customer's account because of the transactions effected in the account on that day. The record shall be preserved for at least twelve months, and shall show, for each account, the amount of margin so required and the time when and manner in which the margin is furnished or obtained. The record shall be maintained in a manner satisfactory to the Exchange."

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The Business Useletter

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Finance

The margin account

Suppose the broker inadvertently lets your account become undermargined and doesn't notify you. You, however, know about it but don't do anything. Then four months later the broker discovers his mistake, calls for margin and sells you out when you fail to meet his call. Do you have any right against the broker—on the theory that he breached his fiduciary duty to you when he failed to notify you promptly after your account first became undermargined?

A federal district court thought so when it awarded damages of $20,000 to a customer who had been sold out under these circumstances. But on appeal the decision was reversed. The 5th Circuit Court of Appeals ruled that the investor's behavior (sitting back and doing nothing) barred his recovery. The court refused to place the customer in what it regarded as a position of "heads-I-win-tails-you-lose." In so doing it rejected the approach of another Court of Appeals, the prestigious Second Circuit (New York and environs).

Current situation: The customer has little chance of winning in the 5th Circuit, but a good chance in the 2nd Circuit. Also: good chance that the issue will eventually come before the Supreme Court.

Gordon v. duPont Glore Forgan, Inc., C.A. 5, 12/10/73